



**STATE BOARD OF EQUALIZATION  
STAFF LEGISLATIVE BILL ANALYSIS**

**DRAFT**

Date Amended:	<b>03/13/06</b>	Bill No:	<b>AB 2001</b>
Tax:	<b>Cigarette and Tobacco Products</b>	Author:	<b>Cogdill</b>
Related Bills:			

**BILL SUMMARY**

This bill would allow a distributor to post a security deposit for deferred purchases of cigarette tax stamps in the form of negotiable assets, or as pledge of a secured interest in real property, and delete the January 1, 2007 repeal date to indefinitely extend the following provisions:

- A distributor's election to make payment on a twice-monthly basis for amounts owing for stamps and meter register settings purchased on a deferred basis;
- Reduced security for distributors that elect to make deferred payment on a twice-monthly basis;
- A distributor's election to either file a return and remit payment of the amount of tax due respecting his or her distributions of tobacco products and the wholesale cost during the preceding month on a monthly or twice-monthly basis.

**ANALYSIS**

**Current Law**

Under current Cigarette and Tobacco Products Tax Law, an excise tax of 43 1/2 mills per cigarette (87 cents per package of 20) is imposed on each cigarette distributed. The cigarette tax imposed with respect to the distribution of cigarettes is paid by distributors through the use of stamps or meter impressions. An appropriate stamp or meter impression is required to be affixed to, or made on, each package of cigarettes prior to distribution of the cigarettes, except as otherwise provided.

Current law also imposes a surcharge on tobacco products at a rate to be annually determined by the Board. The tobacco products tax rate is equivalent to the combined rate of tax on cigarettes. Currently, the surcharge rate for fiscal year 2005-06 is 46.76 percent.

**CIGARETTE TAX STAMPS PURCHASED ON A DEFERRED-PAYMENT BASIS**

Every applicant for a license as a distributor is required to file with the Board security in the amount and form as the Board prescribes. The minimum security that is required of any distributor is one thousand dollars (\$1,000). However, distributors desiring to defer payment for stamps and meter impressions are required to furnish a security in an amount as follows:

- Equal to not less than 70 percent of the amount and not more than twice the amount, as fixed by the Board, of the distributor's purchases of stamps and meter

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register settings for which payment may be deferred if a distributor elects to make payments on a monthly basis.

- Equal to not less than 50 percent of the amount and no more than twice the amount, as fixed by the Board, of the distributor's purchases of stamps and meter register settings for which payment may be deferred if a distributor elects to make payments on a twice-monthly basis.

A distributor may elect a monthly or twice-monthly payment basis for amounts owing for stamps and meter register settings purchased on a deferred basis. If a distributor elects a monthly basis, payment is required to be remitted on or before the 25<sup>th</sup> day of the month following the month in which the stamps and meter register settings were purchased. However, if a distributor elects a twice-monthly payment basis, the payment is due based on the following schedule:

- The first monthly remittance would be due on or before the 5<sup>th</sup> day of the month. The amount due would be equal to either one-half of the total amount of those purchases of stamps and meter register settings made during the preceding month or the total amount of those purchases stamps and meter register settings made between the first day and the 15<sup>th</sup> day of the preceding month, *whichever is greater*.
- The second monthly remittance would be made on or before the 25<sup>th</sup> day of the month for the remainder of those purchases of stamps and meter register settings that were made in the preceding month.

A distributor that elects to make deferred payments on a twice-monthly basis is also required to file a report on or before the 5<sup>th</sup> day of the month respecting his or her distributions of cigarettes and purchases of stamps and meter register settings.

The twice-monthly deferred payment option for amounts owing for stamps and meter register settings purchased on a deferred basis and corresponding reduced security will remain in effect until January 1, 2007, and as of that date is repealed.

#### **TWICE-MONTHLY ELECTION TO FILE A RETURN AND MAKE PAYMENT FOR TOBACCO PRODUCTS TAX**

A distributor is authorized to elect to file a return and make payment of the tax due on either a monthly or a twice-monthly basis respecting his or her distributions of tobacco products and their wholesale cost during the preceding month and any other information as the Board may require. If a distributor elects a monthly basis, the distributor is required to file a return and make payment of the tax on or before the 25<sup>th</sup> day of the month following the month during which the tobacco products were distributed. If a distributor elects a twice-monthly basis, the distributor is required to file two returns and make two remittances during the month following the month during which the tobacco products were distributed as follows:

- The first monthly return would be required to be filed, together with the first remittance of tax, on or before the 5<sup>th</sup> day of the month for those distributions of tobacco products that occurred between the first day and the 15<sup>th</sup> day of the preceding month.
- The second monthly return would be required to be filed, together with the second remittance of tax, on or before the 25<sup>th</sup> day of the month for those distributions of

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tobacco products that occurred between the ~~16<sup>th</sup> day and last day of the~~ preceding month.

The twice-monthly payment and reporting basis for distributions of tobacco products will remain in effect until January 1, 2007, and as of that date is repealed.

#### **TYPES OF SECURITY**

Every applicant for a license as a distributor is required to file with the Board security in the form as the Board prescribes. The applicant is allowed to select the type of security he or she prefers. Subject to specific conditions, four types of security are acceptable for purposes of fully complying with the security requirement for deferred payment of cigarette tax stamps or meter register settings. These are:

1. Cash Deposits
2. Deposit accounts in banks, savings banks, and savings and loans including Insured Accounts, Fully Paid Investment, Bonus Investment Certificates and Accumulative Investment Certificates
3. State and Federal Credit Union Shares
4. Surety bonds

Any security in the form of cash, insured deposits in banks or savings and loan institutions, or a bond or bonds duly executed by an admitted surety insurer, payable to the state, conditioned upon faithful performance of all the requirements of the Cigarette and Tobacco Products Tax Law and expressly providing for the payment of all taxes, penalties, and other obligations of the person that arise are to be held by the Board in trust to be used solely in the manner provided.

#### **Proposed Law**

This bill would amend and repeal Sections 30142, 30168, and 30182 of the Revenue and Taxation Code to delete the January 1, 2007, repeal date to indefinitely extend the twice-monthly deferred payment option for amounts owing for stamps and meter register settings purchased on a deferred basis and corresponding reduced security amount, and twice-monthly payment and reporting basis for distributions of tobacco products.

Section 30142 of this bill would also provide that security for a distributor that desires to defer payments for stamps or meter register settings may be in the form of any of the following:

- Cash, or a cash equivalent
- A surety bond
- A pledge of a secured interest in real property
- Negotiable assets, deposited with the Board, including, but not limited to, stocks and bonds

A distributor electing to satisfy the security in the form of a pledge of a secured interest in real property would make a request for this election to the Board. The request for the

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election would contain the address or other means of identification of the real property proposed to be pledged as the security and all pertinent information concerning all encumbrances which constitute liens against that real property, if any. The request must also include a statement authorizing the Board to have the real property appraised by an appraiser selected by the Board and that the distributor will be responsible for the costs of the appraisal.

The Board would determine if the fair market value, as defined, of the real property proposed to be pledged as security is equal to the amount of security required. If the fair market value meets the security required, the Board would notify the distributor of that determination and authorize the distributor to make an election to pledge that real property as security in satisfaction of the security requirement.

If the distributor elects to pledge the real property as security, the distributor would be required to prepare a written statement of a pledge of the distributor's secured interest in the real property, as specified. The Board may also require the distributor, on an annual basis, to provide a current title insurance policy and an environmental report, or insurance in lieu thereof.

If the distributor fails to comply with the provisions of the Cigarette and Tobacco Products Tax Law, the secured interest in the real property would be considered to be property of the distributor to which a perfected and enforceable state tax lien, as described, applies.

"Fair market value" would be defined to mean:

- In the case of encumbered property, 75 percent of the appraised fair market value of the real property, minus the face amount of any existing encumbrance against the real property.
- In the case of unencumbered property, 85 percent of the appraised fair market value of the real property.

This bill would become effective January 1, 2007.

### **Background**

In 2003, the Legislature approved and the Governor signed AB 1666 (Ch. 867, Cogdill) which authorizes a cigarette distributor to elect a twice-monthly deferred payment option for amounts owing for stamps and meter register settings purchased on a deferred basis, reduces the corresponding reduced security amount, and authorizes a tobacco products distributor to elect a twice-monthly payment and reporting basis for distributions of tobacco products.

AB 1666 also required, on or before January 1, 2006, the Legislative Analyst, with assistance of, and based on information provided by, the Board, to prepare a report to the Legislature of the economic impact of the bill. The report was required to include an evaluation of the Board's ability to collect cigarette tax revenues, additional revenues, if any, generated by the twice-monthly payment program, and the ability of distributors to access security bonds.

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The Legislative Analyst's Office<sup>1</sup> report contained the following recommendation:

"In general, the ability of cigarette distributors to defer payment for cigarette tax stamps until sometime after the tax has been collected is appropriate policy. Chapter 867 represented an attempt to improve the ability of distributors to defer payment while not worsening the state's risk in making such delayed payment possible. The program was undertaken at a time when substantially higher cigarette taxes were being discussed. That the program enrolled few participants may in part be due to the fact that the higher taxes were not, in fact, imposed. If new taxes were to be adopted in the future, however, additional program participation could occur. This is because the higher tax amounts would necessitate greater security amounts under the credit option.

"To date, Chapter 867 has had a minor fiscal impact on the state. It appears that minor administrative costs have been more than offset by additional interest earnings. Furthermore, the added exposure to the state from the lower security amount has only marginally increased financial risk to the state. Therefore, we recommend that the program be continued. It may assist the distributor market to continue to be a competitive industry, and may make it more feasible for small and moderate-size wholesalers to continue to compete by expanding their ability to defer payment for cigarette tax stamps.

"If the Legislature chooses to continue the program, it may also wish to consider the following refinements:

**Require BiMonthly Payments From All Payment Deferrers.** Given the additional interest that the state receives by having more frequent remittances, the Legislature may want to require that all distributors that defer payment be required to remit tax proceeds on a bimonthly basis. If this is perceived as too much of an administrative burden for either the BOE or distributors, a tax revenue threshold for such a requirement could be established as an alternative.

**Allow Additional Forms of Collateral by Deferrers.** The Legislature may want to explore other alternatives regarding the posting of security by distributors which defer payment. One option would be to allow for liens on property as a form of security. This would entail a more lengthy process for the state to get paid in the event of a distributor default, but it would free up some capital capacity for the businesses. Another option for posting of security would be through the deposit of negotiable assets-such as stocks or bonds."

### **In General**

Every applicant for a license as a distributor is required to file with the Board a security in the amount and form as the Board prescribes. The minimum security that is required of any distributor is one thousand dollars (\$1,000). However, every distributor desiring to purchase tax stamps or meter register settings on the deferred payment basis would request the Board to set the maximum amount of such purchases the distributor may have unpaid at any time and the amount of the required bond. The maximum amount of stamps and meter register setting purchases for which the distributor may defer

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<sup>1</sup> [http://www.lao.ca.gov/2006/cigarette\\_bonds/cigarette\\_bonds\\_012506.pdf](http://www.lao.ca.gov/2006/cigarette_bonds/cigarette_bonds_012506.pdf)

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payment cannot exceed one and one-half times ~~the distributor's average monthly tax liability based on the distributor's previous six months' experience.~~ Or in the case of a distributor not previously authorized to make deferred payment purchases or a distributor the character of whose business has changed substantially, the maximum amount will be set at one and one-half times the estimated average monthly tax liability as determined by the Board. When a distributor is authorized to purchase stamps or meter register settings on the deferred payment basis, the bond will be fixed in an amount equal to 50 or 70 percent, depending on a distributor's deferred payment basis election, of the amount of deferred payment purchases which the distributor may have unpaid at any time.

The privilege of making deferred payment purchases will be suspended if there is a delinquent balance owing.

## COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the California Distributors Association and is intended to respond to the Legislative Analyst's Office recommendation that the program implemented by AB 1666 be continued and to allow for additional forms of collateral by deferred payment purchasers.
2. **Alternative forms of collateral for deferred payment purchasers.** This bill would allow a distributor purchasing cigarette tax stamps on a deferred payment basis to post a security in the form of negotiable assets (stocks and bonds) or as a pledge of a secured interest in real property. **These types of securities do not comply with the Board's current security requirements and would put cigarette tax revenues** that are deposited into the General Fund, Breast Cancer Fund, Cigarette and Tobacco Products Surtax Fund (Proposition 99) and California Children and Families Trust Fund (Proposition 10) **at significant risk.**

The types of securities currently accepted for credit purchases of cigarette tax stamps guarantee the performance of payment of the excise tax in the event of a default. However, security in the form of stocks and bonds do not have guaranteed performance; stocks can be volatile, while bonds are vulnerable to economic changes that can undermine their value. Any asset with a value that can fluctuate downward makes for an unpredictable form of security that cannot guarantee payment of the excise tax in the event of default.

Allowing a pledge of secured interest in real property as a form of security would also be new to the Board; however, the use of a state tax lien on real property is a collection tool currently used by the Board pursuant to Chapter 14 (commencing with Section 7150) of Division 7 of the Government Code. Allowing real property as a type of security is very different than using real property as one of the various tools used by the Board for the collection of tax. The purpose of security is to *guarantee* payment up to the amount of the security required, whereas a collection remedy is simply a tool to collect, but not a guaranteed payment of, delinquent taxes. For example, collecting delinquent taxes through the use of a state tax lien on real property is a lengthy process. The Board does not collect on that delinquent liability until the real property is sold or refinanced, which can take years. And even if the property is sold, the property may be encumbered to or over the amount of the selling price, leaving no proceeds to apply to the delinquent taxes.

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With millions of dollars in security, the state cannot wait years to collect from a distributor that defaults on its deferred payment for cigarette tax stamps. As such, real property used for security as proposed by this measure would have to be converted to cash through the foreclosure process. This would put the Board, whose function is to administer and collect various taxes and fees, in the real estate business – a business with which the Board is unfamiliar and comes with many risks. The risks and concerns related to accepting a pledge of secured interest in real property are, in part, as follows:

- A pledge of secured interest in real property is simply a promise that does not provide the Board with priority protection through a recorded deed of trust. As such, real property pledged as security could be sold or further encumbered without the Board's knowledge leaving insufficient or no equity as security.

Furthermore, assume that the Board successfully records a state tax lien and forecloses on real property pledged by a distributor for excise tax due on cigarette tax stamps purchased on credit. If the Board is a junior lien holder, the foreclosure process does not wipe out senior lien holders. To obtain title to the property being foreclosed, the Board would have to buy out senior lien holders which are typically larger liens.

- The Board would have to service a senior lien during the foreclosure process. For example, the Board would have to make payments on a first mortgage to avoid a default under that lien.
- Could property outside this state be pledged as security? This would subject the Board to different foreclosure rules, which would require the Board to obtain outside counsel.
- The Board could inherit problem property, such as property with an unknown environmental hazard.
- Real property is not a guaranteed payment for delinquent taxes. There are several factors that can reduce the market value of real property, such as a market downswing, damage to the property, poor maintenance, unexpected use or zoning of adjoining property.

If this bill were signed into law, the Board could potentially have the current amount of security posted (\$107 million) in the form of cash and surety bonds converted to pledges in real property. And this amount could increase substantially with the passage of an initiative currently in circulation for signature that proposes to increase the cigarette tax by an additional \$2.60 per pack of 20 cigarettes.

Not only would allowing security in the form of a pledge of a secured interest in real property put the state at significant risk, it would also put the Board in the business of managing real estate which is outside the Board's purview and something the Board is not equipped to handle. As such, Board staff believes that the bill should be amended to remove the provisions that allow additional forms of security for cigarette tax stamps purchased on a deferred payment basis.

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3. **Distributors purchasing tax stamps on a deferred basis.** Currently, 27 of the 147 distributors licensed with the Board purchase cigarette tax stamps on a deferred basis. In terms of value of the stamps, over 70 percent of all stamp revenue is derived from stamps that have been purchased through deferred payments.

The combined credit limit for distributors purchasing cigarette tax stamps on a deferred basis is approximately \$155 million, with a corresponding security of \$107 million. The credit limit and corresponding security for distributors electing the monthly or twice-monthly payment basis is as follows:

- Distributors electing the **monthly payment basis** have an approximate total credit limit of \$146 million, with a corresponding security of \$102 million.
- Distributors electing the **twice-monthly payment basis** have an approximate total credit limit of \$9 million, with a corresponding security of \$4.5 million.

The Board is authorized to suspend a distributor's privilege to purchase tax stamps on the deferred basis if a distributor fails to promptly pay for stamps when payment is due. If collection of these amounts remain unpaid, the Board could pursue the distributor's security deposit.

4. **What effect has AB 1666 had on the Board?** Since the inception of the twice-monthly payment election for cigarette tax stamps purchased on a deferred-payment basis and corresponding reduced security, two distributors have elected to take advantage of the program. Currently, the Board has one distributor electing to make payments twice-monthly with the reduced security amount.

Implementation of the twice-monthly payment option and corresponding reduced security has had no impact on the Board's ability to collect cigarette tax revenues. However, it should be noted that the Board has not had a collection problem with respect to cigarette tax stamps purchased on a deferred payment basis in the last ten years other than one instance in 2003 involving a bankruptcy case. That case involved a late payment of tax, which was subsequently recovered with interest from the distributor's surety bond.

AB 1666 also authorized a distributor of tobacco products to elect to file a return and make payment of the tax due on either a monthly or a twice-monthly basis respecting his or her distributions of tobacco products and the wholesale cost during the preceding month. However, no tobacco products distributor has elected to file returns or make payments of the tobacco products tax on a twice-monthly basis.

5. **Extending the provisions added by AB 1666 would not be problematic for the Board.** Since the Board already administers the deferred payment options, deleting the repeal date would not be problematic for the Board.

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**COST ESTIMATE**

Indefinitely extending the provisions added by AB 1666 would not impact the Board's administrative costs. There would, however, be an additional cost related to the Board's contract with Bank of America (BoFA) to accept and process twice-monthly payments. The current contract, which will expire on June 30, 2008, is based on the amount of activity for the services provided. As such, any additional distributors desiring to make payments twice-monthly for amounts owing for stamps and meter register settings would increase activity with BoFA and the related cost for services. However, the current contract contains a maximum agreement amount of \$114,696 for the July 1, 2005 through June 30, 2008 contract period.

The Board would, however, incur costs with respect to allowing security in the form of negotiable assets or as pledge of a secured interest in real property for deferred payments for cigarette tax stamps purchases to notify distributors and to update procedures and manuals. The Board would also incur additional costs if any foreclosure actions are actually commenced.

**REVENUE ESTIMATE**

The interest income related to a distributor election to make payment on a twice-monthly basis for deferred purchases of stamps and meter register settings is estimated to amount to approximately \$70,000 annually.

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